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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	IB Docket No. 95-168
Revision of Rules and Policies for the	)	PP Docket No. 93-253
Direct Broadcast Satellite Service	)	

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REPLY COMMENTS OF THE
UNITED STATES DEPARTMENT OF JUSTICE

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IB Docket No. 95-168
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Summary

The United States Department of Justice submits these reply comments. The Department believes that the Commission may exercise reasonable predictive judgment to support adoption of a structural rule barring affiliation between the nation's largest cable television firms and DBS providers in the three primary full-CONUS orbital slots. Here, as the Commission itself recognized after exhaustive study, the MVPD market is already highly concentrated, with cable television firms exercising market power in their service areas. If large cable firms are permitted to control DBS slots, the incentives of both cable and DBS providers to compete may be reduced. A structural rule designed to prevent such anticompetitive effects is supported both by economic analysis, as illustrated by the Department's 1992 Merger Guidelines, and by the limited history thus far of satellite delivered home television.

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REPLY COMMENTS OF THE
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The United States Department of Justice ("Department") submits the following reply comments in the above captioned proceeding. The Department previously submitted Comments in which it suggested, among other things, that the Commission should adopt a structural rule which would prevent the nation's largest cable television firms, or combinations of firms, from owning, controlling or using DBS channels in any of the three primary full-CONUS orbital slots. The rule advocated by the Department would govern only new acquisitions or uses; large cable firms subject to the restriction could bid in a DBS auction, but if such a firm is the winning bidder, it would be required to divest cable assets sufficient to comply with the restriction. In these Reply Comments, the Department responds chiefly to comments related to this aspect of the Commission's rulemaking proceeding.

I. The Commission has at Hand Sufficient Support for a Structural Cable/DBS Cross-Ownership Rule.

Several commenters argue that the Commission may not adopt a structural rule unless it first produces "hard economic or empirical support" showing that cross-ownership between cable and DBS will yield a less competitive MVPD market. E.g. Comments of Tempo DBS, Inc., at 14. In effect these commenters argue that if the Commission were confronted with an open barn door, it could not close the door based on experience and judgment which tell it that the horses will otherwise escape. Rather, the Commission must first produce hard evidence that these particular horses will depart if this particular door is left open. The hardest such evidence will of course soon be an empty barn. Fortunately, the law does not require the Commission to wait for such evidence before it may close the door.

Any rule designed to curtail future industry concentration must be based in part upon a prediction as to what would occur in the absence of the rule. Where factual determinations underlying a rule are "primarily of a judgmental or predictive nature," the Supreme Court holds, "complete factual support in the record for the Commission's judgment or prediction is not possible or required; a forecast of the direction in which future public interest lies necessarily involves deductions based on the expert knowledge of the agency." FCC v. National Citizens Committee for Broadcasting, 436 U.S. 775, 813-14 (1978) (quotation omitted.) The Court repeated this point in FCC v. WNCN Listeners Guild, 450 U.S. 582, 594-95 (1981), and then observed that the FCC's policy there "was in major part based on predictions as to the probable conduct of licensees and the functioning of the . . . market." "These predictions," the Court held, "are within the institutional competence of the Commission." Id. at 595-96. The Commission's duty is to provide a "rational explanation for its conclusion." Id. at 595. Once it does so, its "judgment regarding how the public interest is best served is entitled to substantial judicial deference." Id. at 597.

Here, adoption of a structural rule such as that urged by the Department is fully supported by the exercise of reasonable predictive judgment. The Commission itself completed an exhaustive study of the MVPD market only a year ago. It concluded that this industry is highly concentrated, with cable television firms exercising monopoly market power in their respective geographic areas. 1994 Cable Competition Report, 9 FCC Rcd 7442, 7556, 7540-550 (1994). Information cited by the Commission indicated that cable's market power had not decreased from 1990 to 1994; some information even suggested that cable's market power had actually increased during this period. Id. at 7544-45. This was the same period in which several new MVPD media, including DBS, first emerged.

It appears that there may be room in the MVPD marketplace only for DBS providers at three orbital locations.[1] The risks to competition seem clear if firms with monopoly power in large parts of the nation are permitted to acquire scarce assets that are vital inputs to services that potentially could compete with those monopolies.

The potential effects of cable/DBS cross-ownership are illustrated by the

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[1] See the Department's Comments at 4.

methodology set out in the Department's 1992 Merger Guidelines.[2] This analysis begins with a determination of the relevant market, which almost everyone in this proceeding agrees is the MVPD market. However, the MVPD market consists of various firms that offer a differentiated product. That is, firms in this market offer services that differ across various dimensions, such as the number and type of channels of programming available and the manner in which the programming is delivered to consumers.

Thus, to determine whether common ownership between a large cable firm and a DBS firm is likely to create anticompetitive effects, the economic model to be applied must account for product differentiation.[3] There are two general ways in which models of this type may help explain how cable ownership of DBS can have anticompetitive effects. The first examines how this cross-ownership will affect the incentives that influence the competitive behavior of the cable firm. As discussed below, some economic models indicate that a large cable firm will have an incentive to charge a higher price for its cable service when it also owns a DBS service. This, in turn, may also affect the pricing of the DBS firms in the market. A second scenario relates to the incentives that influence the competitive behavior

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[2] U.S. Department of Justice and the Federal Trade Commission, Horizontal Merger Guidelines, 1992.

[3] For a discussion of product differentiation models, see, for example, Robert D. Willig, "Merger Analysis, Industrial Organization, and Merger Guidelines," Brookings Papers on Economic Activity: Microeconomics, Martin Neil Baily and Clifford Winston, editors, 1991. This article builds on previous work, such as Raymond J. Deneckere and Carl Davidson, "Incentives to Form Coalitions with Bertrand Competition," Rand Journal of Economics, vol. 16, pp. 473-86.

of the DBS service when that DBS service is affiliated with a large cable firm. In comparison to an independent DBS firm, a cable-affiliated DBS firm may have greater incentives to offer a lower-quality or higher-price product. This scenario is also discussed in more detail below.

In a model that allows for product differentiation, and in which all cable and DBS firms are independent, a cable firm, when setting its price in a given local market, will recognize that raising its price is likely to cause it to lose some subscribers, while other subscribers will continue to subscribe at the higher price. The cable firm balances the added revenue it would earn from a higher price charged to customers it expects to retain, which translates into higher profits on those customers, against the revenue it would lose from those customers who would likely switch to other MVPDs.

The extent to which a cable firm loses customers depends, among other factors, on the degree of product differentiation among the firms in the market. An individual firm may compete more strongly with another firm in the market if both firms offer products with similar attributes. A merger of two firms that offer close substitutes for each other may allow the merged firm to profit by unilaterally raising price above the premerger level.[4] A merger of two firms that do not compete closely, however, may not lead to a price increase by the merged entity.

Thus, the effect of cable ownership of DBS is likely to depend, among other factors, on the degree to which cable and DBS are close substitutes for each other.

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[4] See Merger Guidelines, section 2.21.

Though it is clearly the case that various DBS firms are likely to offer services that are close substitutes for each other, it also appears that DBS providers, as a group, offer the closest substitute for the service offered by cable television firms. In other words, cable customers who switch to other firms in response to a price increase will be likely to switch to DBS providers.[5] When the cable firm owns a DBS firm, the cable firm's incentives are likely to change, as compared to the incentives of a cable firm without DBS. After a price increase, some of the cable subscribers who would switch to another MVPD would purchase MVPD services from the DBS firm owned by the cable firm. Those subscribers are not truly "lost," since they are now subscribers of the cable-affiliated DBS service. This creates an incentive for the cable firm to charge a higher price for cable services than it would if all DBS firms were independently owned.[6]

In short, this model indicates that prices are likely to be higher in local markets where there is common ownership between the cable firm and a DBS firm. The total harm from this cross-ownership is likely to increase as the number

[5] DirectTV has submitted some information that generally supports this assumption. Of its approximately 1 million subscribers, 50% are from areas passed by cable. Among those subscribers, 2/3 had cable when they purchased DirectTV's service, and 80% of these subscribers either dropped cable or reduced the amount of cable services purchased. Hausman affidavit, paragraph 15.

[6] In turn, price increases by the cable firm are also likely to lead to higher prices for all of the DBS firms, since these firms now face a combined cable and DBS firm that is not competing as aggressively as it did before the merger.

of subscribers served by the cable firm increases.[7] This analysis supports a structural rule, such as the one proposed by the Department, prohibiting cable firms that reach a given number of subscribers from holding full-CONUS DBS slots.

The above analysis focuses mainly on the incentives of the cable firm when it is affiliated with a DBS provider. But anticompetitive effects can also result from changes in the incentives of the DBS provider when it is affiliated with a cable firm. DBS firms compete, for example, on a quality dimension, such as program offerings, that are set at the national level, and higher quality levels result in higher marginal costs. When a DBS firm decides where to set its quality level, it knows that a quality level lower than that offered by other MVPDs are likely to lead to the loss of some potential customers. A DBS firm, therefore, balances the lower costs associated with lower quality against the lost revenue from customers who elect not to subscribe because of lower quality.

A DBS firm affiliated with a cable firm will likely have different incentives in setting quality than would an independent DBS firm. If the cable-affiliated DBS provider offers lower quality service, some of the customers who elect not to subscribe to its DBS service will instead subscribe to the cable service offered by its affiliate. As the customer base served by the cable firm increases, the

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[7] There are, of course, factors that would attenuate this anticompetitive effect. For example, to the extent the independent DBS firms, or other MVPDs, could reposition themselves such that the lost cable subscribers went to these firms rather than to the cable-owned DBS firm, the cable firm's incentive to raise price would be diminished. See, for example, Merger Guidelines, section 2.212.

incentive for the DBS firm to set quality at a lower level also increases.[8] This is because, for a given lower quality level, the DBS firm will lose a given number of potential subscribers but, as the geographic reach of its cable franchises increases, it is likely to retain a larger number of these customers, as compared to a smaller cable firm.

A cable-affiliated DBS firm is also likely to have incentives different from those of an independent firm in setting prices. Higher DBS prices will yield not only higher DBS margins, but will reduce the migration of cable subscribers to DBS. To the extent that the presence of a less aggressive, cable-affiliated, DBS firm exerts an upward bias upon all firms' DBS pricing, that firm's different incentives will affect DBS prices to consumers.

A cable-affiliated DBS provider might also affect other DBS providers' prices indirectly, through conduct that affects their costs. A cable-affiliated firm may upwardly bias all DBS firms' pricing, for example, by negotiating less aggressively over price with program suppliers, particularly program suppliers affiliated with the DBS firm itself. Suppliers whose programming is in demand may then treat their prices to that DBS firm as a floor for all DBS firms, raising all firms' costs.

Several commenters assert that cable-affiliated DBS firms would not be able to act based on their different incentives because they must compete with

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[8] If, instead, these customers would primarily switch to other DBS firms, rather than to the cable firm allied with the DBS firm, then the DBS firm's incentive, after a merger with a cable firm, to lower quality is reduced. That is because its cable firm does not "capture" any of these subscribers that switch away from its DBS service.

independent DBS firms. This assertion assumes that existing DBS firms will continue to be independent, but in the absence of rules ensuring such independence, the Commission should not rely on that assumption. The Commission's current rules not only permit cable companies to own any DBS firm, they also would permit cable companies to acquire all such firms. If all DBS firms are cable-affiliated, they all will share similar altered incentives.

Moreover, even assuming that some DBS firms remain independent, the cable-affiliated DBS firms will still be subject to incentives different from those of independent DBS providers. They may seek to match their independent DBS competitors, but they would still lack the incentives of an independent firm to offer lower prices or to offer better programs than those competitors. Their likely inclination will be to meet, not beat, their competition. Because of the extremely limited number of firms that will compete in this market, such inclinations would result in a significant loss of competition.

The recent history of satellite delivered television tends to confirm what economic analysis predicts. In its early years, for example, Primestar, owned by a consortium of the nation's largest cable companies, avoided marketing its service in areas served by cable.[9] DirecTV, a cable-independent DBS firm, marketed itself aggressively to all households. These differing strategies created dramatically different subscriber bases. DirecTV reports that approximately 50% to 60% of its

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[9] See Satellite Spotlight: DTH Operator Primestar to Overhaul Image, Satellite News, January 23, 1995.

subscribers come from cable areas; Primestar reports only about 20%.[10] In areas served by the cable companies who own Primestar, former cable subscribers may comprise as few as 1% of Primestar's customers.[11] The two companies' relative growth rates also suggest that Primestar has competed less vigorously. As of the summer of 1995, after less than a year of active marketing, DirecTV had a third more subscribers than Primestar--even though Primestar had been in business serving customers for a much longer time.[12] Only after DirecTV began making inroads among cable subscribers did Primestar commit itself to a major marketing initiative.[13]

Both economic analysis and the factual record suggest that cable-affiliated DBS firms will behave differently from independent firms, with consequences that

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[10] See Michael Burgi, DBS Targets Cable Subs, Mediaweek, September 25, 1995, at 12; Jim McConville, Cable Faces Renewed Satellite Competition, Broadcasting & Cable, June 12, 1995, at 29; Direct Broadcast Enlivens Heated Race to Interactivity, Interactive Marketing News, February 3, 1995. Primestar's lower share of subscribers in cabled areas may be partially due to the fact that it uses a medium-power satellite technology that requires a larger dish and that is more attractive in non-cabled areas.

[11] See Bill McConnell, It's Dish-to-Dish Combat for DBS, Warfield's Business Record, April 28, 1995, at 1 (according to Primestar/Comcast representative, "Primestar has 3,000 subscribers in the state of Maryland. At last count, fewer than two dozen have switched from cable to Primestar. So, essentially, nobody's switching."); Barbara De Lollis, It's Hot: Digital Satellite Service Receiver Delivers up to 150 Channels to TV Sets, The Fresno Bee, November 23, 1994, at F1 (according to Continental Cablevision spokesman, "less than 1 percent" of Primestar customers switched from cable).

[12] See Executive Update: Does Being First Pay Off?, Investor's Business Daily, June 15, 1995, at A4.

[13] See The New America Star Wars, Investor's Business Daily, November 28, 1994, at A6.

directly affect competition in the MVPD market. If the past is any guide, a cable-affiliated DBS provider will compete against cable companies only to the extent necessary to prevent cable subscribers from defecting to a non-affiliated DBS provider. Competition in the MVPD market is therefore better served by a Commission policy that encourages the emergence of DBS providers that are not affiliated with the nation's largest cable operators.

II. Discrimination by Wholesale DBS Providers and Other Matters.

Two commenters take issue with the Commission's characterization of HITS-type service as "wholesale" DBS service, since such service would not entail the resale of programming by a DBS provider.[14] In its own Comments, the Department followed the Commission's lead and used the term "wholesale DBS service" to describe the aggregation, digitization, compression, encryption, and transport of video signals, and recognized that, strictly speaking, the DBS firm would not be reselling the programming.[15] It is these services, which are likely to be provided by a firm with substantial market power, that should be the subject of the rules suggested by the Department, regardless of whether the resale of programming by a DBS provider is involved. If more precise terminology than "wholesale DBS" is needed, it should be adopted, but the result should be the

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[14] See Comments of TEMPO DBS, Inc. at 25-27; Comments of Primestar Partners, L.P. at 31-32.

[15] See the Department's Comments at 11.

same. As the Department showed in its Comments, the proposed rule will protect competition among MVPDs and programming vendors, by preventing the exercise of market power by "wholesale DBS" providers.[16]

At page 19 of its Comments, the Department expressed its general support for the Commission's concerns about allowing DBS providers to aggregate more than 32 DBS channels. In the interests of clarity, we should add that these concerns are most appropriate with respect to full-CONUS orbital slots. If the

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[16] In his November 20, 1995 Declaration supporting Tempo's comments Bruce M. Owen points out that restrictions on vertically integrated DBS providers may in some instances reduce incentives to create new DBS programming. Because the Department was cognizant of this concern, we recommended that the Commission allow for exemptions when they were in the public interest.

remaining DBS slots would otherwise remain unused, social welfare should be enhanced by allowing their use even by DBS firms with 32 other channels.

Respectfully submitted,

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